What if the Bear Market is Already Over?

Everyone is waiting for recession—and the bear; meanwhile, many markets around the world already have corrected as much as 20% to 30%.

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Key takeaways

- Everyone seems to be looking for the next recession—and the next bear market—but what if both already happened?
- The global economy has been slowing for a year and a half in what can be termed an "industrial recession," and many stock markets have declined 20% to 30%, either in price or valuation or both.
- Stock markets can correct in many ways, from price drawdowns to valuation de-ratings to simply lagging their respective long-term trend lines; for the past 21 months, global equities have done all three.
- Based on price patterns since 2009, one could make the argument that stocks are ready to break out to the upside once again.

Financial markets around the world have been struggling with numerous crosscurrents, as evidenced by the almost two-year holding pattern for most equity indexes. Since its valuation peak in January 2018, the S&P 500® price-only index has gained a mere 5%, whereas in a single "normal" year, it would be expected to gain around twice that. Worse, the MSCI All Country World Index (ACWI) has made less than zero progress (-3%) in the same 21-month time span.

And so, after a year and three-quarters of sideways, we may well be getting to that point where the market declares itself in one direction or another: Either we break out of late-cycle purgatory and start making consistent new highs, or we enter a bear market.

The global slowdown, already underway, is being met with more and more monetary stimulus. The only questions on investors' minds is whether this slowdown is morphing into a recession and, if so, whether the monetary response from the European Central Bank—and now also the U.S. Federal Reserve—will be enough to stop it.

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Now that the Federal Reserve has delivered its third rate cut of 2019, the odds of a fourth before year-end have dropped to about 1-in-4. The market's hunger for future cuts may subside even more in light of the recent announcement that the Fed plans to buy $60 billion or more worth of Treasury bills per month to address the market's liquidity needs. (Fed Chair Jerome Powell added that "This is not QE. In no sense is this QE.")

Indeed, just recently the forward curve indicated a reduction in the expected number of interest rate cuts, shifting from three or four cuts down to two or three cuts over the next few years, although I believe the change is more likely the result of de-escalation in the U.S.-China trade dispute over the past few weeks.

Will this third cut to the interest rate plus billions of dollars of monthly T-bill purchases be enough? The Fed seems to think so, given that it only reluctantly went along with the market's demand for policy easing. Hopes at the Fed seem to be for a repeat of the mid-cycle adjustments of 1995 and 1998. Likewise, the stock

EXHIBIT 1: Could it be, the bear snuck by?

Price Level Change (%), Select Indexes (2018–2019)

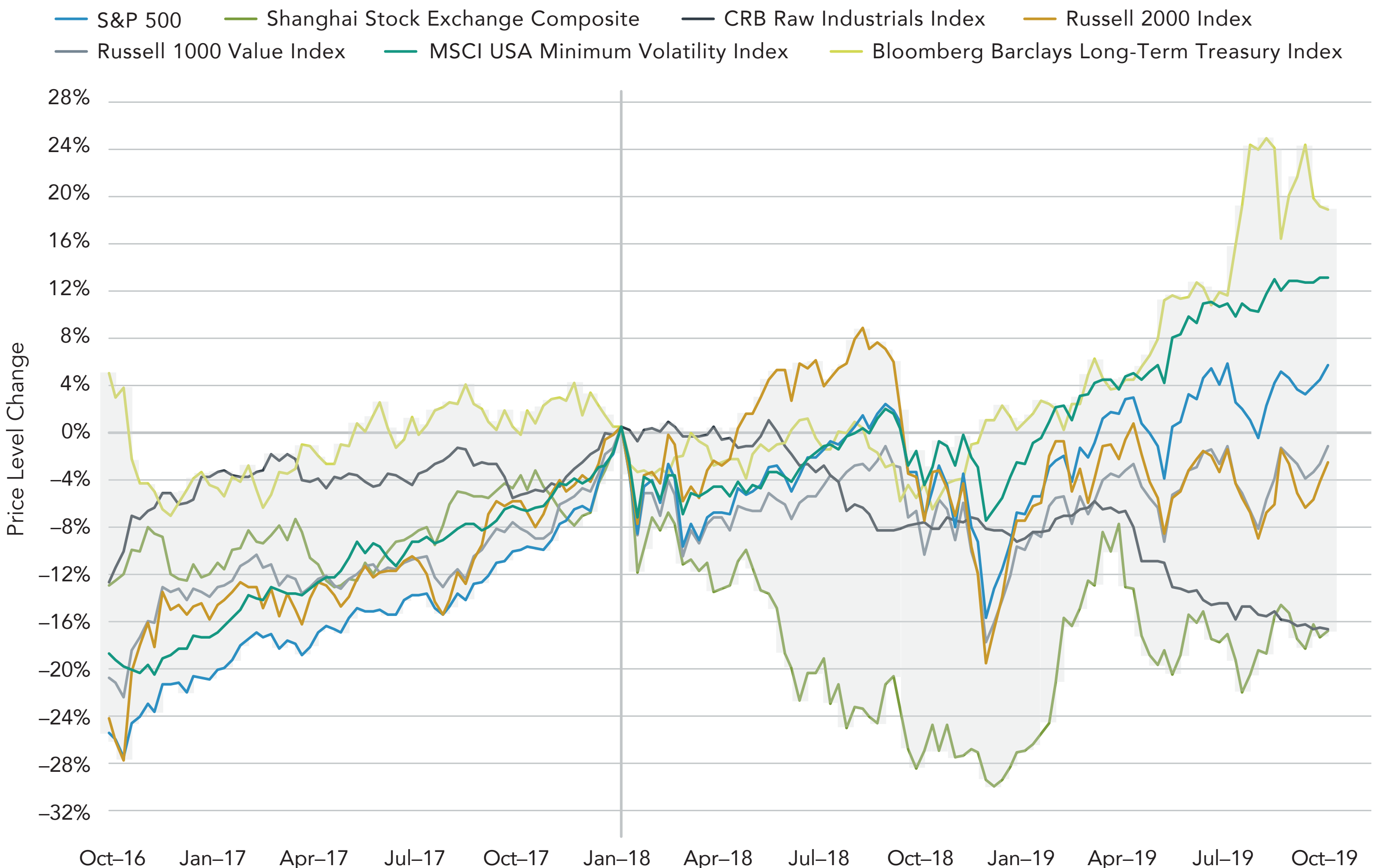


Chart is centered on the January 2018 valuation peak for indexes indicated. Sources: Fidelity Investments, Bloomberg Finance LP, Haver Analytics; weekly data through 10/15/19. It is not possible to invest directly in an index. All indices represented are unmanaged. All indices include reinvestment of dividends and interest income unless otherwise noted. Past performance is no guarantee of future results.

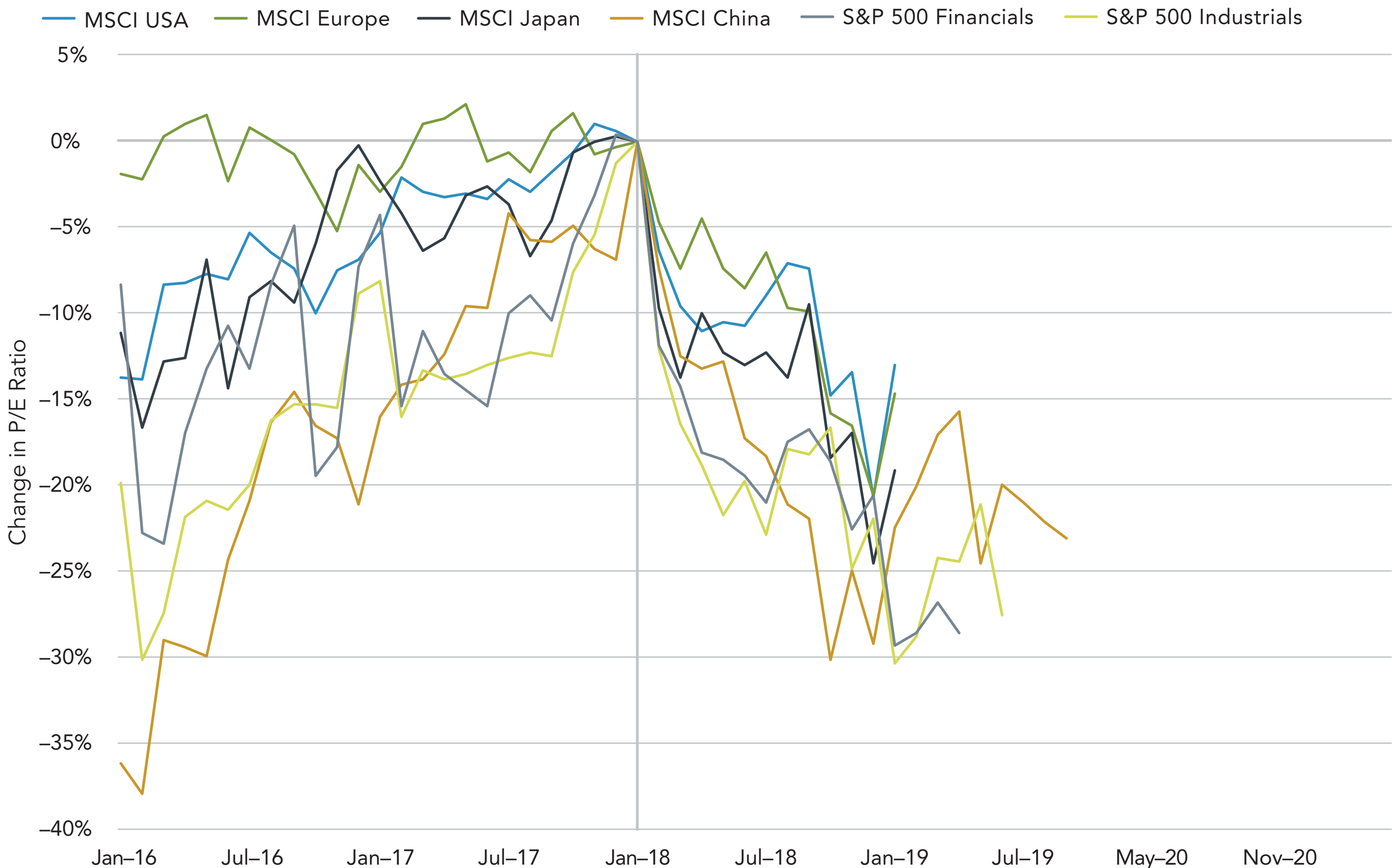
market appears to be following that analog pretty closely, and the yield curve has started to "dis-invert," which in my view is a good thing.

But the stakes are high. The U.S. economy is now in the sub-50 PMI[1] zone, wherein the odds historically have favored bottom fishing, with investors trying to hook "undervalued" securities before they spurt higher. In the past, when the PMI dove below 50, the S&P 500's 12-month forward return turned compelling more often than not—with a positive showing 10 out of 15 times since the 1950s, by my count. The problem is that at those times when the turn didn't come quickly, it ended up coming from much lower levels. In other words, the left tail (outsized losses) can really hurt when trying to catch a falling knife.

Earnings growth in the U.S. has slowed almost to zero—and, for the rest of the world, remains in negative territory. As the Q3 earnings season kicks into high gear, I'm interested to see whether the quarter follows in the footsteps of Q1 and Q2. During those earlier quarters, the growth estimate started the earnings season around -3% to -4%, only to end up just above zero once enough

EXHIBIT 2: Valuations are all over the map—but most have gone south

Forward (Next 12 Months) P/E Ratios, Select Indexes



Sources: Fidelity Investments, Bloomberg Finance LP, Haver Analytics; monthly data through 9/30/19. Forward P/E valuations based on projected EPS for the next 12 months. It is not possible to invest directly in an index. All indices represented are unmanaged. All indices include reinvestment of dividends and interest income unless otherwise noted. Past performance is no guarantee of future results.

companies beat their previously lowered guidance. As of this writing, the Q3 estimate sits at roughly -3.7% with around 200 S&P 500 companies reporting so far. Meanwhile, the calendar 2019 estimate is closing in on 1% (down from 1.9% a week or so ago and 2.3% a week before that) and the 2020 estimate is above 10%. Of course, that 2020 number involves some downside risk if the usual Q4 estimate's downward drift continues.

Trying to determine when the next recession will strike and to what degree it will knock the stock market remains a favorite pastime of just about everyone these days—and for good reason. After a 10-year quintupling in the S&P 500 price index (counting from its March 2009 low), uncertainty certainly seem high. Investors have been waiting for the "big one" for some time now.

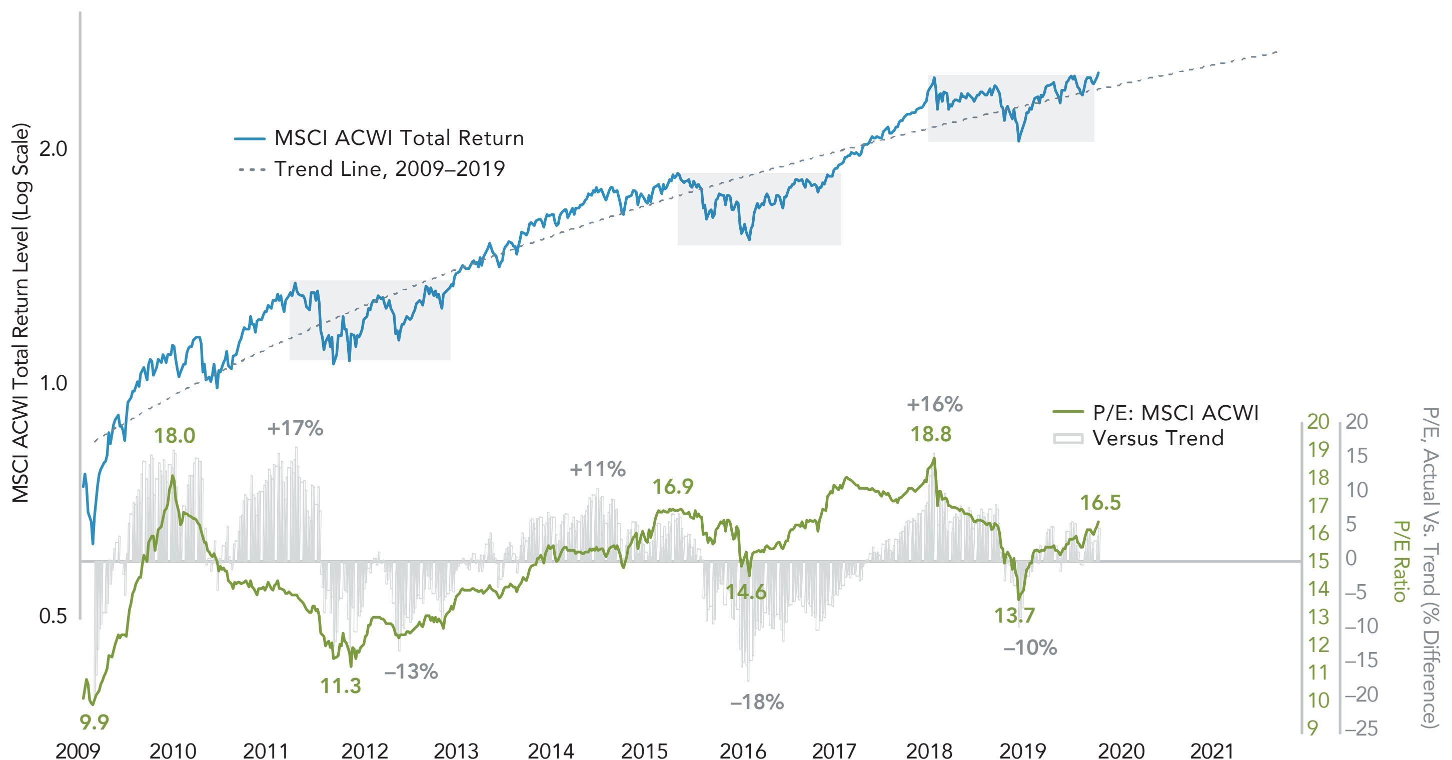
But what if we are waiting for something that has already happened? What if the bear market already ambled by? With the S&P 500 hitting yet another all-time high, that may seem like a silly thing to ask, but the fact is that many other markets have been in a 21-month-long correction in terms of price, time, or valuation.

A correction can be measured in more ways than one. A sudden drawdown of 20% or more is the most traditional, of course—and by the way, such a drawdown took place in the fourth quarter of 2018 (Exhibit 1). But one also can look at stock valuations or measures of time, i.e., how long the market has lagged its long-term trend.

On the valuation side, many forward price-earnings (P/E) ratios around the world have suffered drawdowns of 25%

EXHIBIT 3: The global stock market doesn't sit still

MSCI ACWI Rallies, Corrections, and P/E Trends (2009–2019)



Shaded areas in upper panel highlight significant performance swings. Sources: Fidelity Investments, Haver Analytics; weekly data through 10/15/19. It is not possible to invest directly in an index. All indices represented are unmanaged. All indices include reinvestment of dividends and interest income unless otherwise noted. Past performance is no guarantee of future results.

to 30% from the January 2018 valuation peak (Exhibit 2). That's a meaningful haircut, and one could easily make the case that this constitutes a bear market in and of itself. P/E ratios have been under pressure for almost two years, with China and the other emerging markets leading the way to the downside with 30% drawdowns.

In the past, non-U.S. equities (both developed- and emerging-market) generally outperformed the U.S. stock market when the global cycle recovered or accelerated. We aren't seeing that yet, but with a "skinny" deal on U.S.-China trade seeming likely, not to mention a potential Brexit resolution, perhaps the global animal spirits will revive.

In terms of trend, Exhibit 3 charts the total return of the MSCI ACWI against its trend line since the 2009 low. The bottom panel shows the MSCI ACWI's P/E ratio over time, as well as the index's deviation from its P/E trend line. As can be seen, the market is in a constant state of flux, like a pendulum swinging from above trend to below and back; it rarely just sits there on the trend line. (One also can see what I meant when I noted earlier that the MSCI ACWI has backpedaled from its 2008 high.)

So, over the past ten years or so, we observe a clear pattern of the stock market rallying hard (i.e., with a slope greater than the trend line), then stalling out for a number of months, then finding its footing again to stage another run, and so on. The result is that we have a fairly harmonious-looking pattern of advances followed by consolidations/corrections. The 2009–2010 run led to the 2011 correction (including a 21% drawdown), the 2012–2014 up years proceeded to the 2015–2016 down years (with two 15% declines), and the 2016–2017 rally led to the 2018–2019 correction (20% decline). This pattern of strong advances followed by shallow, time-based corrections fits well with the narrative that we remain, in fact, in a secular bull market that could last many more years.

Exhibit 3 also highlights that these last three time-and-price corrections took the MSCI ACWI from around 10% to 15% *above* its trend line to 10% to 15% *below* trend. Based solely on the index's harmonious wave pattern, it seems to me that we could be about to embark upon another bull leg. After last week's U.S.-China trade thaw—or at least potential thaw—along with renewed not-QE asset purchases from the Fed, perhaps we now have a narrative to support an upward breakout. If so, the market may well look past any Q3 earnings misses toward a brighter 2020.

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Endnote

[1] The Institute for Supply Management (ISM) Manufacturing Index, also called the Purchasing Managers' Index (PMI), is a survey of U.S. purchasing managers in a certain economic sector. A PMI value over 50 represents expansion of the sector compared with the previous month, while a reading under 50 represents a contraction; a reading of 50 indicates no change.

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